



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 12, 2004

Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Oxley:

Thank you for your February 4th letter regarding state-sponsored 529 tuition savings plans. Your letter expressed concern about recent press reports raising a number of issues regarding the operation of state-sponsored 529 tuition savings plans, including whether high fees in some plans may have the effect of offsetting tax benefits that Congress granted to parents investing for their children's college needs.

I share your concern regarding the ability of parents to understand the operation of these plans and the economic implications that high fees may have on families as they save for their children's higher education. I have asked the staff to answer the questions you raised in your letter. Their responses are set out in the attached memorandum. As you will see, the current state of affairs with respect to 529 plans is complicated and likely difficult for parents to understand.

In addition, as part of the Commission's new focus on risk assessment, I have created a task force, made up of SEC staff from the Divisions of Investment Management, and Market Regulation, the Offices of Economic Analysis, Investor Education and General Counsel, to examine these issues more thoroughly. While the work of the "Chairman's Task Force on College Savings Plans" has only just begun, its mission is to closely examine issues raised by the structure and sale of college savings plan participants.

I look forward to sharing the Task Force's findings with you, and to working with you as we consider ways to enhance disclosure to investors about state-sponsored 529 tuition savings plans. In the meantime, I hope you find the attached information helpful. Please feel free to contact me at (202) 942-0100 or Annette L. Nazareth, Director of the Division of Market Regulation, at (202) 942-0090 with any questions.

Sincerely,

A handwritten signature in black ink that reads "Bill Donaldson".

William H. Donaldson

Attachment

Attachment

Date: March 2, 2004

To: Chairman William H. Donaldson

From: Annette L. Nazareth, Director, Division of Market Regulation



Re: Questions from Chairman Oxley relating to investments in 529 plan interests

This memorandum responds to a letter dated February 4, 2004, from Chairman Michael G. Oxley of the House Committee on Financial Services. Chairman Oxley expresses various concerns about tax-advantaged qualified tuition savings programs sponsored by state governments, commonly known as 529 tuition savings plans or 529 plans ("529 tuition savings plans"). Chairman Oxley requests detailed information about the regulation and oversight of such plans and their service providers under the federal securities laws. He also asks for certain information about the public disclosure made by state 529 tuition savings plans and whether their high fees and expenses may offset the tax benefits that Congress granted to parents investing for their children's college needs.

This memorandum provides a general background of state 529 tuition savings plans, a brief discussion of some results from our limited review of disclosure by such plans, and, finally, more detailed information in response to Chairman Oxley's questions.

Background Information About State 529 Tuition Savings Plans

As discussed more fully below, state 529 tuition savings plans were authorized by, and are primarily a product of, the federal tax laws.¹ As a general matter, they are not regulated under the federal securities laws. As a result, we do not have a direct source of information about these plans. Nevertheless, we have reviewed press reports, representations made to the staff by several plan sponsors in requests for no-action letters, and publicly available information on a small number of plans sponsored by various states. Accordingly, the characteristics and trends that we discuss are limited to the information we have surveyed and may not be representative of all 529 plans in all states.

State-sponsored 529 tuition savings plans have existed since 1997, after Congress amended Section 529 of the Internal Revenue Code to permit the states to offer them. Section 529 permits only states or agencies or instrumentalities of states to sponsor tuition savings plans, unlike prepaid tuition plans. The states generally establish these tuition savings plans as state trusts, either directly through legislation or by granting authority to establish such trusts to the state agency that administers 529 programs. In either case, these state trusts are considered instrumentalities of their respective states for

¹ Section 529 of the Internal Revenue Code provides for two types of tax-advantaged qualified tuition programs; prepaid tuition programs and state-sponsored tuition savings plans. Prepaid tuition programs involve the prepayment of tuition expenses for students at colleges and universities.

federal securities law purposes, and generally operate in reliance on legal opinions of counsel to that effect. Section 529 and the rules promulgated by the Internal Revenue Service establish the permissible parameters and required elements of 529 tuition savings plans, including eligibility, maximum contributions, control over investments, permissible uses of contributions and tax treatment of earnings on contributions. Because state tuition savings plans were the subject of the recent press reports cited in Chairman Oxley's letter, our responses to his questions are limited to this type of plan.

There are two categories of 529 tuition savings plans, distinguishable primarily by the methods through which they are sold. The first category is composed of 529 tuition savings plans in which investors acquire interests in the state trust directly from the state trust or a state agency on behalf of the trust, and do not involve a sales intermediary ("direct-sold 529 plans").² The second category is composed of 529 tuition savings plans in which the state trust interests are distributed through financial intermediaries, such as brokers, dealers, bank municipal securities dealers and other banks ("broker-sold 529 plans"). Recent press reports indicate that broker-sold 529 plans now account for approximately 75% of all sales of interests in 529 tuition savings plans.³

Investors' contributions in direct-sold 529 plans, which are held in separate accounts in the state trust fund, are generally invested by the trust fund in state-managed portfolios that, in turn, usually invest their assets in several mutual funds or other pooled investment vehicles. Contributions to broker-sold 529 plans are also generally held in a separate account maintained in a state trust in the name of the account owner, and are invested by the state trust, based on the owner's instructions, directly in one or more mutual funds that are available to participants in the particular plan. As discussed below, certain differences between the types of plans result in different treatment under the federal securities laws. Our responses to Chairman Oxley's questions therefore distinguish between these plans where appropriate.

Overview--Difficulties Faced By Parents Investing For Children's Education

We believe that the wide variations in disclosure among the various state 529 tuition savings plans we reviewed, as well as the absence of significant securities law protections, makes it difficult for investors to fully understand the options that are available to them with respect to these tax-advantaged college savings plans. Before proceeding to the more specific questions raised by Chairman Oxley, we thought it would be helpful to highlight two key areas that illustrate some of the difficulties parents face in making an informed choice among the plans.

- ***Less disclosure than that provided to other mutual fund investors.*** Although contributions to 529 plans are largely invested in mutual funds, 529 plan

² Several states do, however, contract out some or all of the customer service, recordkeeping and other work associated with direct-sold 529 plans.

³ See J. Kim, "Assets in 529 Plans Jumped 83% to \$35B in 2003", Dow Jones News Wire (February 4, 2004) (quoting Whitney Dow, the director of education-savings research at Financial Research Corporation).

investors may receive little or no information about the underlying funds in which their contributions are invested. The federal securities laws do not require that 529 plan investors receive the same quality of information that other mutual fund investors receive. Moreover, 529 plan investors do not receive the periodic reporting that other mutual fund investors receive. As a result, parents trying to evaluate the appropriateness of an investment in a 529 plan, relative to other investment options, may not have the information needed to properly evaluate their choices.

- ***Lack of standardized disclosure.*** The level of disclosure, the type of information disclosed, and the manner in which the information is presented to investors varies among states and among different plans offered by the same state. This lack of standardization makes it difficult for parents to compare various 529 plans. As a result, it is difficult to account for differences in performance among many plans. For example, some plans report annual returns before plan fees are deducted, while others report results after fees are deducted. It is also difficult to account for discrepancies between the returns on underlying investments and the reported returns of plan portfolios.

In addition, the lack of standardized disclosure may well explain variations in fees and plan administration that we have found as part of our limited review of disclosure of state 529 tuition savings plans. Two examples follow.

- ***Variations in fees.*** In reviewing two plans that are often recommended in the financial press, the Utah Educational Savings Plan Trust and the College Savings Plan of Nebraska, we found variations in fees for exactly the same underlying investment. For example, for a \$10,000 initial investment in the same underlying fund (tracking the S&P 500 index), and assuming an 8% annual return, a parent investing for a child's education in Utah's plan would have about 6.0% (or about \$2,113) more to spend on the child's education after 18 years than if the parent had invested directly in Nebraska's plan. This is because of Utah's lower fees. We use these plans as examples because they are among the lowest-cost plans available. However, more dramatic discrepancies exist with respect to other, higher-cost plans which have similar, though not identical investment choices. For example, the parent who invested in Utah would have about 20.7% (or about \$7,728) more to spend on the child's education after 18 years than if the parent had invested through a broker in the Equity Growth Portfolio (using the "Alternative A" investment option) of the Rhode Island JPMorgan Higher Education Plan, again assuming 8% annual returns and assuming the parent is not a Rhode Island resident.⁴

⁴ Based on our limited review of disclosure by these 529 tuition savings plans, we understand the fees for the specified investment options to be:

We believe that the lack of standardized disclosure of fees makes it difficult for parents to compare the effect of the various plans' fees on the plans' performance and may explain the difference in fees in our example above.

- ***Variations in disclosure about plan administration.*** Parents may also be confused by the differences in disclosure of administration of various plans, some of which have a direct impact on investment returns. For example, unlike many other plans, investor contributions to the Virginia Education Savings Trust will not be invested by the plan into the underlying portfolio for up to one month. Any interest on the contribution during this period is paid to the Education Savings Trust to defray unspecified administrative expenses, essentially making this delay in investment an interest-free loan from investors. This is on top of the administrative fee charged by the Virginia Education Savings Trust included in the expenses of each portfolio.⁵

Responses to Chairman Oxley's Questions

1) Please explain how the current federal securities regulatory scheme applies to 529 plans and to those who provide services to and sell interests in these plans to investors.

As a general matter, the federal securities laws apply to 529 tuition savings plans in a relatively limited manner. The state trusts through which these plans are offered to the public are instrumentalities of the states that establish them. As a result, the securities issued by the state trusts are municipal securities. The Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act") expressly do not apply to agencies, authorities, or instrumentalities of states.⁶ The offer and sale of 529 tuition savings plan interests, as municipal securities, are also exempt

Utah Educational Savings Plan Trust (Option 4): annual expense ratio of 0.275% of average daily net assets plus an additional annual fee of \$25. (Source: "Utah Educational Savings Plan Fact Booklet", available at http://www.uesp.org/UESP_BENFITS/Fact_Booklet/fact_booklet.html.)

College Savings Plan of Nebraska (Vanguard Institutional Index Fund Portfolio): annual program management fee of 0.60% of average daily net assets, plus annual expense ratio of 0.10% charged by the underlying fund, plus an additional annual fee of \$20. (Source: "College Savings Plan of Nebraska Enrollment Handbook", available at <http://www.planforcollegenow.com/pdfs/enrollment/EnrollHandbook.pdf>.)

Rhode Island JPMorgan Higher Education Plan (Equity Growth, Alternative "A" Option): if no breakpoint discounts are available there is a sales load to non-Rhode Island residents of 4.75%, plus an annual expense ratio of 1.35% of average daily net assets, plus an additional annual fee of \$25. (Source: "JPMorgan Higher Education Plan Program Description", available at http://jpmorganfleming.chase.com/mutualfunds/education/docs/he_program_description.pdf.)

⁵ Source: "Virginia Education Savings Trust Enrollment Kit" at page 15 (definition of "Pending Settlement Period") (available at http://www.virginia529.com/VEST_2003.pdf).

⁶ See Section 2(b) of the Investment Company Act and Section 202(b) of the Advisers Act.

from the registration requirements of the Securities Act of 1933 (“Securities Act”).⁷ In addition, the interests, as well as the state issuers, are not subject to the registration and reporting provisions of the Securities Exchange Act of 1934 (“Exchange Act”).⁸ Due to these exemptions, the disclosure provisions of the Securities Act and the Exchange Act do not apply to interests in the state 529 plan trusts. As a result of these statutory exemptions, the Commission does not directly regulate the offer and sale of interests in 529 tuition savings plans or the plans themselves, other than, as discussed below, through the operation of the anti-fraud provisions of the federal securities laws and laws regulating brokers, dealers and municipal securities dealers.⁹

The federal securities laws do apply to, and the Commission does directly regulate, the brokers, dealers and municipal securities dealers that sell interests in 529 tuition savings plans. By prohibiting them from selling interests in 529 tuition savings plans unless certain conditions are met, the Commission is able to indirectly regulate certain limited aspects of the offering and sale of plan interests to the public.¹⁰

In addition, some states retain investment advisers that are registered with the Commission to manage 529 tuition savings plan assets. Finally, the assets in 529 tuition savings plan trusts are in large part invested in registered investment companies. As discussed below, both registered investment advisers and registered investment companies are subject to applicable federal securities laws.

⁷ See Section 3(a)(2) of the Securities Act.

⁸ Because interests in 529 tuition savings plans are “municipal securities” under the Exchange Act, however, their distribution by brokers, dealers and municipal securities dealers is governed by rule 15c2-12 under the Exchange Act. For the definition of “municipal securities”, see Section 3(a)(29) of the Exchange Act. Rule 15c2-12 prohibits a broker, dealer or municipal securities dealer from participating in an offering of interests in a 529 tuition savings plan absent an undertaking by the issuer or another obligated person to disclose certain financial and operating information about the 529 plan issuer and the interests into a nationally recognized municipal securities information repository (NRMSIR) or state information depository (SID). NRMSIRs and SIDs are not affiliated with the Commission. The information must be made available at the time of the offering and on an on-going basis. Thus, limited information about 529 plan interests and their issuers is required to be publicly disclosed and updated. That information, however, is not filed with the Commission and is less comprehensive than information that must be disclosed about issuers and securities in offerings that are subject to registration with the Commission. Furthermore, retail investors may have difficulty accessing the information and a fee is typically charged for such access.

⁹ See Statement of the Commission regarding disclosure obligations of municipal securities issuers and others, SEC Rel. No. 33741 (Mar. 9, 1994).

¹⁰ See *supra* note 8. We note, however, that subject to certain limitations described in more detail below, banks that effect transactions in municipal securities like 529 plan interests are not be required to register with the Commission and the Commission has no jurisdiction over them. This is described in more detail in the response to question 2.

2) *Please explain in detail the oversight role that the Commission and the self-regulatory organizations play in this area. How, if at all, do existing statutory or regulatory exceptions or exemptions (as well as formal and informal Commission and SRO guidance) impact the ability of the Commission and/or the SROs to oversee this area?*

Issuers of 529 Tuition Savings Plan Interests.

As noted above, the Commission does not directly regulate state issuers of interests in 529 tuition savings plans or the offer or sale of trust interests in those plans, other than through the anti-fraud provisions of the federal securities laws and rules applying to municipal securities underwriters and dealers. This is because the state trusts established to be the vehicles through which these plans are offered to the public are considered to be instrumentalities of the respective states that establish them and, therefore, the interests in 529 tuition savings plans as interests in these state trusts, are municipal securities under the federal securities laws. As municipal securities, the offer and sale of the interests in 529 tuition savings plans are statutorily exempted from the registration requirements of the Securities Act and the securities and the state issuers are not subject to the registration and reporting requirements of the Exchange Act.¹¹

Also as noted above, the Investment Company Act does not apply to 529 tuition savings plans. Section 2(b) of the Investment Company Act makes the Act inapplicable to any agency, authority or instrumentality of a state. Because 529 tuition savings plans are “established and maintained by a State or agency or instrumentality thereof,”¹² they are excluded entirely from both the disclosure and substantive regulatory requirements of the Investment Company Act.

Despite the lack of regulatory oversight over the issuers of interests in 529 tuition savings plans, those issuers, as well as other participants in the offer and sale of such interests, continue to be subject to the anti-fraud provisions of the Securities Act and Exchange Act. Although the anti-fraud provisions do not impose specific disclosure requirements, they generally prohibit persons, including issuers of municipal securities, municipal securities underwriters and dealers, from making materially misleading statements or material omissions in connection with the sale of any municipal security,

¹¹ Based on the direct state involvement in the operation and oversight of 529 tuition savings plans through the state trusts, the Divisions of Corporation Finance and Market Regulation have provided assurances that they would not recommend enforcement action to the Commission if various states offered and sold interests in 529 tuition savings plans without registration of the offering or sale of those interests under the Securities Act, and without compliance with the registration and certain other provisions of the Exchange Act. As a result of the available exemptions from registration, the disclosure provisions of the Securities Act and Exchange Act do not apply to the interests in 529 tuition savings plans. The staff has addressed only the federal securities law implications of the sales of interests or accounts in the state trust funds, and has not provided any assurances with regard to the federal securities law implications of any of the underlying investments that may be held by the trusts.

¹² IRC § 529(b)(1)(A)(ii).

including interests in 529 tuition savings plan trusts.¹³ In addition, such issuers are subject to the laws of their respective states, including certain state securities laws.¹⁴

Registered Investment Companies.

Based on our limited survey of 529 tuition savings plans, it appears that plan assets are largely invested in registered investment companies. These underlying registered investment companies are subject to the same degree of Commission regulation and oversight as any other registered investment company. The Investment Company Act imposes extensive disclosure obligations regarding both investment companies themselves and the securities that they offer for sale. The Investment Company Act also contains substantive regulations designed to prevent fraud and limit conflicts of interest between shareholders and managers, as well as various risk, borrowing and capital structure limitations. Regulation under the Investment Company Act also entails extensive recordkeeping requirements and regular examinations by Commission staff.

Investors in 529 tuition savings plans, however, hold interests in a municipal issuer—the state trust fund—that is exempt from the bulk of the federal securities laws. Thus, many of the substantive aspects of the Investment Company Act and the other federal securities laws do not operate to the direct benefit of 529 plan investors. For example, there is no federal securities law obligation that a 529 tuition savings plan disclose conflicts of interests to investors. Because 529 plan investors are not considered to be beneficial owners of the investment companies that serve as the underlying investments in their 529 plan accounts, the federal securities laws do not require delivery of disclosure documents such as annual reports, semi-annual reports, and proxy statements. These documents must generally be delivered directly to beneficial owners of investment company shares.¹⁵ Similarly, 529 plan investors do not have voting rights in the registered investment companies held in their accounts.

Investment Advisers to 529 Tuition Savings Plan Portfolios.

Just as 529 tuition savings plans themselves are not regulated under the Investment Company Act, Section 202(b) of the Advisers Act makes the Advisers Act inapplicable to any agency, authority or instrumentality of a state, or to any officer or employee of the state acting in his or her official duty. Thus, to the extent that a state agency or instrumentality manages the investments in a state's 529 tuition savings plan,

¹³ For example, Rule 10b-5 under the Exchange Act prohibits the use of any device, scheme or artifice to defraud or the making of any untrue statement of a material fact or the omission of any material fact necessary to make statements made, in light of the circumstances in which they were made, not misleading.

¹⁴ The North American Securities Administrators Association (NASAA) is a central resource for information on state securities laws and regulations.

¹⁵ As discussed more fully below, however, Rule 15c2-12 under the Exchange Act imposes certain minimum disclosure obligations on municipal securities offerings that involve registered brokers, dealers or municipal securities dealers.

the agency and its employees would be exempt from the Advisers Act by operation of Section 202(b).

We understand, however, that many sponsors of direct-sold 529 plans hire private-sector investment advisers either to directly manage 529 plan assets or to act as investment consultants to the agency responsible for managing plan assets. These investment advisers, unless they qualify for a specific exemption from registration under the Advisers Act, are generally required to be registered with the Commission.¹⁶ Among other things, registered investment advisers are subject to extensive disclosure and recordkeeping requirements, as well as routine inspections and surprise examinations by Commission staff. All investment advisers, whether registered or not, are subject to the anti-fraud provisions of the federal securities laws. In addition, a general fiduciary obligation applies to all investment advisers, regardless of whether they are registered. As fiduciaries, they are required to act with utmost good faith toward, and with full and fair disclosure to, their clients.¹⁷

Broker-dealers and municipal securities dealers.

Broker-dealers and bank municipal securities dealers¹⁸ effecting transactions in 529 tuition savings plan interests, typically involving broker-sold plans, must comply with applicable federal securities laws and the applicable rules of the Commission and self regulatory organizations (“SROs”), in particular the Municipal Securities Rulemaking Board (“MSRB”). A bank, however, that acts only as agent in the purchase of municipal securities, and is not otherwise a municipal securities dealer, is exempt from the definition of “broker” under the Exchange Act.¹⁹ As such, it is not a municipal securities dealer and is not subject to the rules of the MSRB with respect to purchases of interests in 529 plans. The Commission does not have authority to regulate such banks when they effect transactions in 529 tuition savings plan interests.²⁰

¹⁶ The Advisers Act contains a number of limited exemptions from registration, the most common of which applies to investment advisers with fewer than 15 clients and who do not hold themselves out to the public as investment advisers. In addition, investment advisers with less than \$25 million in assets under management are generally required to register with appropriate state securities regulators rather than with the Commission. See Sections 203(b) and 203A of the Advisers Act.

¹⁷ See SEC v. Capital Gains Research Bureau, 375 US 180, 194 (1963).

¹⁸ “Municipal securities dealer” is defined in section 3(a)(3)(o) of the Exchange Act. Municipal securities dealers are banks that are in the business of buying and selling municipal securities. A bank that acts as a dealer or principal, directly or through a separately identifiable department or division (a “SID”), in transactions involving municipal securities must register itself or its SID with the Commission as a municipal securities dealer. The rules of the MSRB apply to all municipal securities transactions effected by the registered municipal securities dealer, including transactions in 529 plan interests conducted on an agency basis.

¹⁹ See section 3(a)(4)(B)(x) of the Exchange Act.

²⁰ Banks are overseen by bank regulators, including the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

SRO rules that apply to transactions in 529 tuition savings plan interests effected by brokers, dealers and municipal securities dealers consist primarily of MSRB rules which were written with municipal bonds in mind. Applicable MSRB rules include requirements relating to the delivery and content of confirmations and rules relating to sales practices. In addition, MSRB has adopted rules that apply more specifically to transactions in interests in 529 tuition savings plans, for example recordkeeping requirements relating to periodic statements delivered to customers in lieu of individual confirmations.²¹

In addition, while broker-dealers that effect transactions in 529 tuition savings plan interests must comply with MSRB rules, they may also be required to comply with certain NASD rules. For example, NASD-member broker-dealers that, in their advertisements about 529 tuition savings plans, refer to the performance of the registered investment companies underlying the plan must comply with NASD's advertising rules.²²

The Commission has responsibility for overseeing the MSRB, and for overseeing the regulation of transactions in interests in 529 tuition savings plans, through its oversight of the MSRB's rulemaking process. As such, the Commission may approve or disapprove of MSRB rules that apply to such transactions. In addition, the Commission recently proposed to enhanced confirmation and point-of-sale disclosure for certain types of securities, including interests in 529 tuition savings plans.²³ Furthermore, as part of its regular examination of broker-dealers, the Commission reviews records relating to sales of 529 plan interests, as well as sales of mutual fund shares.

Investment Advisers to Individual 529 Plan Investors.

In general, persons who provide advice to investors with regard to investing in interests in 529 plans, and who are not registered representatives of broker-dealers or municipal securities dealers, may fall within the definition of an investment adviser for purposes of the Advisers Act, and would be subject to general fiduciary obligations and the Advisers Act's anti-fraud provisions. They may also be required to be registered as

²¹ Other MSRB rules that apply to transactions in 529 tuition savings plan interests are available at <http://www.msrb.org/msrb1/mfs/mfs5.asp>.

²² See NASD Special Notice to Members 03-17 (March 2003) (available at <http://www.nasdr.com/pdf-text/0317ntm.pdf>).

²³ See Rule Proposal 33-8358 (available at <http://www.sec.gov/rules/proposed/33-8358.pdf>). The proposed new confirmation rules would require brokers, dealers and municipal securities dealers to provide customers with information about distribution-related costs that investors incur when they purchase interests in 529 tuition savings plans. They would also require disclosure of distribution-related arrangements involving those types of securities that pose conflicts of interest for brokers, dealers and municipal securities dealers, as well as their associated persons.

The proposed new point of sale disclosure rule would require brokers, dealers and municipal securities dealers to provide point of sale disclosure to customers about costs and conflicts of interest relating to, among other things, the offer and sale of 529 plan interests. In contrast to confirmation disclosure, which a customer will not receive in writing until after a transaction has been effected, point of sale disclosure would specifically require that investors be provided with information that they can use as they determine whether to enter into a transaction to purchase one of those types of securities.

investment advisers either with the Commission or with an appropriate state securities regulator. To the extent that an investment adviser is required to be registered with the Commission under the Advisers Act, the adviser is subject to regulation under the Act and the rules promulgated thereunder. As discussed above, regulation under the Advisers Act generally involves disclosure of information about an adviser, its disciplinary history, conflicts of interest, and fees.

3) *How, if at all, does the information provided in these plans differ from the information provided to mutual fund investors?*

Prospectus Disclosure.

Because the Investment Company Act does not apply to state instrumentalities, the specific disclosure requirements that apply to investment companies do not apply to 529 tuition savings plans.²⁴ As discussed above, each 529 tuition savings plan is established pursuant to applicable state law. While we have not engaged in a comprehensive survey of the laws of the several states and their individual disclosure requirements, we have formed generalized conclusions as to the overall nature of the disclosure provided in the offering documents of 529 tuition savings plans. Based on our limited review of disclosure by 529 tuition savings plans, these plans do not appear to be providing disclosure comparable to that required under the Investment Company Act. This may be due to the nature of the investment decision being made. For example, 529 plan documents tend to focus a significant amount of disclosure on the tax and educational savings aspects of the plans. 529 plan descriptions generally provide a great deal of information about eligibility, tax benefits and penalties, contribution limits and permissible uses for plan distributions, and explain other concepts that are specific to 529 tuition savings plans. Because of this, disclosure regarding the actual investment options within both adviser-sold and direct-sold 529 plans is generally secondary in terms of emphasis and detail.

Moreover, the level of disclosure, the type of information disclosed, and the manner in which the information is presented to investors varies among states. It also varies among different plans offered by the same state. For example, in the case of broker-sold 529 plans, many plan documents simply list the investment companies into which participants can direct contributions, and refer investors to the investment companies' prospectuses for further information. In the case of direct-sold 529 plans, plan documents typically offer prospective investors a choice of several managed portfolios that invest in investment companies or other pooled investment vehicles, and provide generalized disclosure about the underlying investments, including information such as investment company investment objectives, risks, performance, and expenses. This disclosure, while generally more helpful than information provided in broker-sold 529 plans, is less complete and not as standardized in terms of emphasis and presentation as an investment company's prospectus.

²⁴ In addition, based on our review of 529 plan disclosure, it seems certain that states do not require disclosure comparable to that required under the Investment Company Act.

In contrast to the information provided to 529 plan investors, investment company investors receive a prospectus that provides information that is essential to an investor's decision concerning whether to invest in a particular fund. The Commission has adopted a disclosure system under the Investment Company Act that requires disclosure of specific information in a standardized format. For example, the prospectus provides specific information about risks, fees and expenses, the investment objective of the fund and various conflicts of interest. Thus investors in registered investment companies are provided information material to their specific investment decision in a format that allows them to compare different investment companies.

Periodic Reporting.

In addition to prospectus delivery and other requirements relating to the registration of investment companies and their securities, the Investment Company Act also requires investment companies to file with the Commission, and deliver to shareholders, annual and semi-annual reports that provide ongoing disclosure of material information. These periodic reports generally contain important information such as management's discussion of the fund's performance, a list of the fund's portfolio holdings, and the fund's financial statements. Federal securities laws do not require 529 tuition saving plans to disclose this type of information to investors and it is unclear whether state laws require any similar reporting.

Rule 15c2-12 under the Exchange Act prohibits a broker, dealer or municipal securities dealer from participating in an offering of interests in a 529 tuition savings plan unless there is an undertaking by the issuer or another obligated person to disclose certain financial information into a nationally recognized municipal securities information repository (NRMSIR) or state information depository. However, Rule 15c2-12 was written with municipal bonds in mind and does not address the needs of investors in 529 tuition savings plans. As currently written, Section 15B(d) of the Exchange Act substantially limits the Commission's authority to address these needs.

4) *On what basis do states select investment managers to manage their plans? To what extent is the basis for selecting managers disclosed to investors?*

The Commission has little information about how states select investment managers to manage their 529 tuition savings plans.²⁵ We note that, although many states

²⁵ Interestingly, even though states oversee 529 plan managers, a representative of the College Savings Plan Network, an industry organization, recently was quoted as stating that "[m]any state contracts make it difficult to fire the fund companies unless there is a material breach of fiduciary duty. . . . But what specifically constitutes a breach is often unclear." P. Wang, "How 529s Got Stuck; State College Savings Plans Were a Terrific Idea. Too Bad Some States Made Bad Deals With The Wrong Companies", *Money* (January 1, 2004); P. Wang, "The Trouble With 529 Plans; More and more, states are messing with a good thing with fees, commissions and bum funds" *Money* (October 3, 2003) (available at http://money.cnn.com/2003/10/07/pf/college/529_0310/).

Further, the general treasurer of Rhode Island was quoted in an article about changing that state's 529 plan investment adviser, stating that the contract, which ends in 2005, "would take a team of lawyers to break." See J. Kimelman, "Fund Scandal Puts College Saving Plans on Alert", *The New York Times* (Nov. 23, 2003).

retain one or more program managers, including a number of well-known financial services firms, to manage some or all of their 529 programs, information about the selection process does not generally appear to be disclosed in the 529 plan materials available to investors.²⁶

By way of contrast, the Commission requires investment companies to provide certain information to investors about the approval of the funds' investment advisory contracts. For example, investment companies are required to include in their registration statements information regarding the basis for their board's decision to renew existing advisory contracts.²⁷ In addition, the Commission has recently proposed amendments to several rules and forms that would require investment companies to provide their shareholders with enhanced and more timely disclosure regarding the reasons for their boards' approval of investment advisory contracts.²⁸

5) *What fees and other costs do investors incur by investing in 529 plans? To what extent, if at all, do fees and other costs associated with investing in 529 plans differ from similar non-529 investments? What explains these differences? What explains the tremendous differences in overall fees and other costs among plans? Are there plans, as the Newsday article suggests, where the overall fees and other costs are so high (compared to similar non-529, non-tax-advantaged investment options) that they could actually outstrip the tax benefit that Congress has attempted to provide?*

a) *What fees and other costs do investors incur by investing in 529 plans?*

As noted above, we have limited access to information that would allow us to provide an informed response to this question. Based on our review of some 529 plans, however, it appears that fees associated with 529 plans include enrollment or application fees, annual account maintenance fees, program management fees, administrative fees, and asset-based fees. These are in addition to the fees of the investment companies in which the 529 plan invests. We are not aware that Section 529 of the Internal Revenue Code places any restrictions on the fees and expenses to which 529 plan assets may be subject.

In addition, broker-sold 529 plans may invest in investment company share classes that are subject to "sales charges" or "loads", charged either at the time of the

²⁶ To the extent that states make their selection processes for government contractors open to the public, there may be information on the selection criteria available elsewhere.

²⁷ The Commission also requires that investment company proxy statements that seek shareholder approval of an investment advisory contract must contain a discussion of the basis for the board of directors' recommendation that shareholders approve the contract.

²⁸ See Investment Company Act Release No. 26350 (Feb. 11, 2004). Under the proposed amendments, a mutual fund would be required to provide investors with a discussion of certain specific factors that go into a board's determination to hire an investment adviser. These factors would include the nature, extent and quality of the adviser's services, the costs of those services, and an indication of whether the board made cost comparisons between the approved advisory contract and other similar contracts.

initial investment or at the time of the redemption, that are designed to compensate the broker, dealer or municipal securities dealer for its sales efforts on behalf of the 529 plans. The amount of the load depends on the fund and the share class purchased and may be reduced based on the amount invested or time that the investment is held. Some states structure their broker-sold 529 plans so that residents of the plan sponsor's state do not bear any loads.

- b) **To what extent, if at all, do fees and other costs associated with investing in 529 plans differ from similar non-529 investments? What explains these differences? What explains the tremendous differences in overall fees and other costs among plans?**

Based on the information available to us, it appears that the primary differences between the fee structure of 529 plans and that of typical mutual funds is the additional layer of fees charged at the 529 plan level that are added to the fees and expenses of the investment companies in which the plan invests.

Section 529 of the Internal Revenue Code does not specify how, or with whom, states may invest contributions to their 529 plan trusts. As a result, states generally permit 529 plan investors to direct the investment of their contributions in a variety of underlying investment companies, which may include investment companies with relatively low expenses, such as mutual funds, as well as actively managed funds with higher expenses. Moreover, states may contract with a wide variety of financial service firms to provide services to their 529 tuition savings plans, some of which charge lower fees than others. Thus, it appears that the choices the states make in these matters largely determine the fees and expenses that 529 plan investors directly or indirectly bear. To a certain extent, differences in fees are sometimes difficult for investors to ascertain, especially in 529 plans where fee disclosure is not prominent.

- c) **Are there plans, as the Newsday article suggests, where the overall fees and other costs are so high (compared to similar non-529, non-tax-advantaged investment options) that they could actually outstrip the tax benefit that Congress has attempted to provide?**

As has been reported recently in several press articles, including those referred to in Chairman Oxley's letter, fees associated with 529 plans may well offset some of the intended tax benefits associated with 529 plans, particularly if investors purchase interests in broker-sold plans instead of interests in a taxable, but low cost mutual fund. For example, a broker-sold plan may charge a 5.50% load for investments in its class A shares and have aggregate annual fees of 2.0%. If \$10,000 were invested in this plan, after 10 years the investment would grow to \$16,923.51, assuming 8% annual returns.²⁹ If \$10,000 were invested instead in a taxable index fund that charges 0.50% aggregate annual fees and no load, after 10 years, and again assuming 8% annual returns, and also assuming no dividends are declared and a 10% capital gains tax is paid at the end of the

²⁹ \$10,000 - \$550 load = \$9,450 initial investment. 8% annual return on investment -- 2.0% annual fees = 6.0% annual increase in investment. Therefore, $\$9,450 \times (1.06)^{10} = \$16,923.51$.

10 year period, the investment would grow to \$18,549.28, or more than \$1,625.77 more than the 529 plan.³⁰ While we recognize that this is not an “apples-to-apples” comparison, we believe it reflects a practical reality for investors: higher fees, whether charged as a load or as an annual asset-based fee, reduce the after-tax returns that investors ultimately realize. This is true of all investments, whether taxable or tax-advantaged.

It is important to note that many 529 plans, in particular direct-sold plans and broker-sold plans that waive loads, offer lower cost options which may well preserve the tax benefit Congress intended to grant to investing parents. It is also important to note that, while any fee will reduce the return on an investment, many other factors may affect the overall returns on investments in 529 plan interests. These factors include the actual return on investment, whether states permit tax deductions for investments (some, but not all, states permit deductions by their residents for investments in their plans), and whether states charge fees to investors who choose to move their investment to another state’s 529 plans.

6) *For a typical 529 plan, how are the fees and other costs to investors of the plan allocated among the state sponsor, the company managing the plan, brokers selling investments in the plan, and others? Are there significant variations among plans in this area?*

Because the Commission does not directly regulate state 529 tuition savings plan issuers or their securities offerings, the staff has no other source of information about how fees are allocated among the state sponsors and the adviser other than information that has been released publicly by the state sponsors. While we are not aware of any restrictions under the Internal Revenue Code on the ability of states and program managers and broker-dealers to allocate fees, recent press reports have suggested that some states receive annual fees of 0.1-0.6% of assets under management. While we currently have no basis for describing the allocation of fees to broker-dealers, the Commission’s recent proposal on mutual fund confirmation disclosure³¹ would require confirmations to include a detailed break-down of the commissions and fees a broker-dealer receives in connection with a transaction in interests of a 529 tuition savings plan. The broker-dealer would also be required to disclose some of this information to the investor at the point-of-sale.

cc: Alan L. Beller, Director, Division of Corporation Finance
Paul F. Roye, Director, Division of Investment Management

³⁰ Because there is no load, \$10,000 is the full initial investment in this hypothetical. 8% annual return on investment – 0.5% annual fees = 7.5% annual increase in the value of the investment. Therefore, $\$10,000 \times (1.075)^{10} = \$20,610.32$; $\$20,610.32 \times .90$ (reflecting deduction for long-term capital gain) = \$18,549.29.

³¹ Rule Proposal 33-8358. For a brief discussion of this proposal, *see supra* note 23.

MICHAEL G. OXLEY, OH, CHAIRMAN

U.S. House of Representatives
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February 4, 2004

ROBERT U. FOSTER III
STAFF DIRECTOR

Honorable William H. Donaldson
 Chairman
 Securities and Exchange Commission
 450 Fifth Street, N.W.
 Washington, DC 20549

Dear Chairman Donaldson:

As you know, tax-advantaged qualified tuition programs (state-sponsored 529 college-savings plans) offer families the opportunity to obtain tax-free growth and distribution on the money they save and invest for college costs. The popularity of 529 plans continues to surge as every state and the District of Columbia operate these plans. After Congress enhanced the tax incentives in the 2001 tax relief law, Americans invested approximately \$20 billion in these plans in 2002 and \$35 billion in 2003, according to a recent *Wall Street Journal* article.

Given the important role that 529 plans play in enabling parents to save for their children's education, as well as the substantial sums being invested in these plans, I have become concerned about certain aspects of some of these plans. For example, the *Journal* has asserted that the mutual fund companies and investment advisers hired by the states to operate these plans have been increasing their brokerage commission fees to entice more financial advisers to market their plans. The *Journal* has also reported that investors "could end up paying surprisingly high fees for a pretty simple financial product."

Perhaps most troubling, a *Newsday* article that appeared in late December suggested that the fees charged by these state-sponsored plans are so exorbitant that they may actually outstrip the tax-benefits that Congress has attempted to provide hard-working families through the plans. This same article indicated that states are not putting in place adequate procedures to monitor the performance and operation of the investment managers they hire to run their plans. I am also concerned about the tremendous differences in overall fees and other costs among what appear to be similar 529 plans.

In light of these concerns, I would appreciate responses to the following:

- 1) Please explain how the current federal securities regulatory scheme applies to 529 plans and to those who provide services to and sell interests in these plans to investors.

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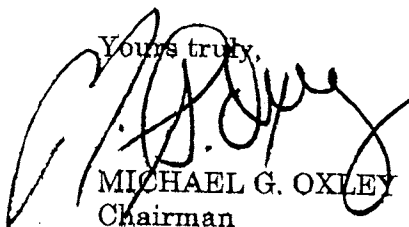
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The Honorable William H. Donaldson
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- 2) Please explain in detail the oversight role that the Commission and the self-regulatory organizations play in this area. How, if at all, do existing statutory or regulatory exceptions or exemptions (as well as formal and informal Commission and SRO guidance) impact the ability of the Commission and/or the SROs to oversee this area?
- 3) How, if at all, does the information provided to investors in these plans differ from the information provided to mutual fund investors?
- 4) On what basis do states select investment managers to manage their plans? To what extent is the basis for selecting managers disclosed to investors?
- 5) What fees and other costs do investors incur by investing in 529 plans? To what extent, if at all, do fees and other costs associated with investing in 529 plans differ from similar non-529 investments? What explains these differences? What explains the tremendous differences in overall fees and other costs among 529 plans? Are there plans, as the *Newsday* article suggests, where the overall fees and other costs are so high (compared to similar non-529, non-tax-advantaged investment options) that they could actually outstrip the tax benefit that Congress has attempted to provide?
- 6) For a typical 529 plan, how are the fees and other costs to investors of the plan allocated among the state sponsor, the company managing the plan, brokers selling investments in the plan, and others? Are there significant variations among plans in this area?

Thank you for time and consideration of this important matter.

Yours truly,



MICHAEL G. OXLEY
Chairman

MGO:jd